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SUBJECT: RURAL FINANCE INITIATIVES STILL STRUGGLING

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SUMMARY

1. (SBU) New rural finance initiatives continue to struggle in China's countryside one year after their introduction because they are not commercially viable. Promoting private banks' involvement in the rural sector through the establishment of Village Banks is the right approach, by increasing competition, but the current policy remains too restrictive according to Beijing-based contacts. Financial policymakers in the provinces maintain that promoting rural finance is an uphill battle, particularly because of the lack of agricultural insurance. End Summary.

MEETINGS IN BEIJING AND HEBEI

2. (SBU) Deputy Assistant Secretary of Treasury Bob Dohner met with rural finance contacts on the margins of Secretary Paulson's visit to Beijing on April 3. Econoff met with officials at the Hebei Provincial Financial Securities Working Leading Group Office on April 17 to hear their views on implementation of rural finance initiatives.

RURAL FINANCE IN CHINA: FACING MAJOR CHALLENGES

3. (SBU) Sari Soderstrom, Rural Sector Coordinator at the World Bank's Beijing Office, stated during her April 3 meeting with DAS Dohner (outlining many of the same themes in reftel) that China's efforts to reform its rural finance sector faces difficulties because of farmers' inability to use land as collateral, the lack agricultural insurance, and the continuing trend of farmers leaving the countryside to work in cities. She said China's rural financial sector also must overcome the legacy of the failed Rural Credit Cooperatives (RCCs), and the Central Government continues to work towards RCC reform. The reform faces an inherent conflict, as the government wants the RCCs to become more commercialized while at the same time better serve farmers, but in China's current environment, most loans to farmers are not commercially viable, Soderstrom stated.

4. (SBU) Tang Min, Deputy Secretary General of the China Development Research Foundation and former Chief Economist at the Asian Development Bank's Beijing Office agreed, stating that a purely commercial approach in rural finance will not be successful, especially since new financial institutions also will struggle to break through the RCCs' monopoly in rural areas. Both Tang and Soderstrom stated that the impetus for current rural finance initiatives remains largely social stability rather than financial reform.

NEW INITIATIVES: RIGHT DIRECTION BUT WRONG WAY

15. (SBU) Tang said the Central Government's efforts to launch new Village Banks are important in order to break up the RCCs' monopoly and open up competition in rural areas. While Village Banks help move rural finance reform in the right direction by promoting private sector involvement, however, they are being introduced in the wrong way because the policy is too tight, Tang said. He noted that current regulations on Village Banks restrict their operations to one county and require a commercial bank to serve as the main shareholder in the Village Bank with 20 percent of the invested capital.

16. (SBU) Since early 2007, 100 new Village Bank projects have been launched in China, Tang said, but the coverage area remains small as there are approximately 3000 rural counties. Tang believes HSBC's decision to establish a Village Bank in Hubei Province last year was motivated solely by political reasons to accelerate regulatory approval of coastal and urban branches. It will be especially difficult for Village Banks to earn a profit because interest rates are capped at 15 to 18 percent, which Tang said is considered too low for viable microfinance projects.

IMPLEMENTATION: THE VIEW FROM HEBEI

17. (SBU) Fang Changkun, Vice Director of the Hebei Financial Securities Working Leading Group Office, and Wang Liugen, Director of the Leading Group's Finance Department, told Econoff on April 17 that Hebei has been quick to embrace the Central Government's new rural finance initiatives, including establishing Village Banks and promoting microfinance projects, but encouraging new institutions to set up in rural areas or existing commercial banks to extend credit to farmers remains an uphill battle. Hebei now boasts many different financial institutions that offer financial services to

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farmers, including commercial banks, RCCs, and microfinance organizations, and two Village Banks in Tang Shan and Zhangjiakou that will come on-line later this year, but banks do not yet understand the seasonal cycles in China's rural areas and the needs of Hebei's farmers, Fang said.

18. (SBU) Wang said that the biggest challenge for rural finance in Hebei is the low coverage rates for agricultural insurance. Insurance companies remain wary of offering policies in rural areas because of low profitability and high risk, but the government is pushing those companies to be more responsive to farmers, Wang said. Rural finance also is hindered in Hebei by a poor regulatory environment and farmers' lack of access to financial information, he lamented. (Note: Contacts at two microfinance NGOs that operate in Hebei Province previously told Econoff that projects designed for rural areas often are implemented in urban areas as it is easier for microfinance organizations to identify urban shopkeepers as potential loan applicants than farmers. End Note.)

COMMENT: MOVING SLOWLY

19. (SBU) Despite the fanfare with which the Central Government unveiled new rural financial reforms in 2007 (reftel) we continue to hear from contacts in Beijing and the provinces that rural finance initiatives have made little progress. Rural finance projects continue to face huge underlying challenges, and banks entering the market do so largely for political reasons rather than profit considerations. Rural finance was not mentioned prominently during the March session of the National People's Congress, and financial reforms continue to be much more focused on commercial banks in urban areas.